No. 90-516

IN THE

Supreme Court of the United States

October Term, 1990

JILL S. KAMEN,

Petitioner,

v.

KEMPER FINANCIAL SERVICES, INC., and
CASH EQUIVALENT FUND, INC.,

Respondents.

On Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

BRIEF FOR THE BUSINESS ROUNDTABLE AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENTS

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Dated: February 19, 1991

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v.

KEMPER FINANCIAL SERVICES, INC., and
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RESPONDENTS.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

MOTION OF THE BUSINESS ROUNDTABLE FOR LEAVE TO FILE BRIEF AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENTS

The Business Roundtable hereby moves for permission to file the accompanying brief *amicus curiae* in support of respondents in this action.

The Business Roundtable is an association of 200 major corporations, represented by their chief executive officers. The Roundtable was founded in 1972, in the belief that business executives should take an increased role in public policy debates. Since 1972, the Roundtable has issued a series of frequently cited white papers regarding important corporate governance issues, including *Statement of The Business Roundtable: The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation*, 33 Bus.

Law. 2083 (1978), *Statement of The Business Roundtable on Corporate Responsibility* (1981), *Statement of The Business Roundtable on the American Law Institute's Proposed 'Principles of Corporate Governance and Structure: Restatement and Recommendations'* (1983), and, most recently, *Statement of The Business Roundtable: Corporate Governance and American Competitiveness*, 46 Bus. Law. 241 (1990).

The issue before this Court concerns the pre-litigation demand requirement. This requirement is a substantive rule of law that ensures that shareholder derivative actions do not "undermine the basic principle of corporate governance that the decisions of a corporation—including the decision to initiate litigation—should be made by the board of directors or the majority of shareholders." *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 530 (1984). As an association including many of the corporations upon whose behalf shareholder derivative litigation is purportedly brought and as an association whose members are the parties most directly affected by this form of litigation, The Business Roundtable has an important interest in (and an important perspective regarding) the rules governing the initiation of such litigation.

The Business Roundtable believes that the case before the Court presents two important questions that have not been fully briefed in this action by the parties: (1) whether state law governs the substantive law of demand underlying Federal Rule 23.1's procedural requirement, and (2) if this Court determines that federal law governs the demand issue, whether the "universal" demand requirement adopted by the court of appeals should be rejected due to the tremendous uncertainty and confusion for the courts litigants which would be created between a *federal* universal demand requirement and the *state* corporate law issues that would surround such a requirement.

Counsel of record for petitioner has refused to consent to the filing of this brief because counsel does not believe that there are questions in the case which require further briefing. Counsel of record for petitioner reached this determination without reviewing the draft of this brief that was offered by The Business Roundtable, and refused to discuss the issue with counsel for The Business Roundtable. Counsel of record for respondents has consented to the filing of this brief.

Respectfully submitted,

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Dated: February 19, 1991

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BRIEF FOR THE BUSINESS ROUNDTABLE AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENTS

INTEREST OF THE BUSINESS ROUNDTABLE

The Business Roundtable is an association of 200 major corporations, represented by their chief executive officers. The Roundtable was founded in 1972, in the belief that business executives should take an increased role in public policy debates. Since 1972, the Roundtable has issued a series of frequently cited white papers regarding important corporate governance issues, including *Statement of The Business Roundtable: The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation*, 33 Bus. Law. 2083 (1978), *Statement of The Business Roundtable on*

Corporate Responsibility (1981), *Statement of The Business Roundtable on the American Law Institute's Proposed 'Principles of Corporate Governance and Structure: Restatement and Recommendations'* (1983), and, most recently, *Statement of The Business Roundtable: Corporate Governance and American Competitiveness*, 46 Bus. Law. 241 (1990).

The issue before this Court concerns the pre-litigation demand requirement. This requirement is a substantive rule of law that ensures that shareholder derivative actions do not "undermine the basic principle of corporate governance that the decisions of a corporation—including the decision to initiate litigation—should be made by the board of directors or the majority of shareholders." *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 530 (1984). As an association including many of the corporations upon whose behalf shareholder derivative litigation is purportedly brought and as an association whose members are the parties most directly affected by this litigation, The Business Roundtable has an important interest in (and an important perspective regarding) the rules governing the initiation of such litigation.

SUMMARY OF ARGUMENT

The Business Roundtable submits this brief in support of the *result* reached in favor of respondents Kemper Financial Services, Inc. and Cash Equivalent Fund, Inc. in the District Court for the Northern District of Illinois (reported at 659 F. Supp. 1153) (Pet. App. 33a-60a) and the Court of Appeals for the Seventh Circuit (reported at 908 F.2d 1338) (Pet. App. 1a-32a). Both of these courts dismissed petitioner's claim under section 20(a) of the Investment Company Act of 1940, 15 U.S.C. § 80a-20(a), due to petitioner's failure to make a pre-litigation demand.

The Business Roundtable, however, disagrees with the reasoning utilized by the courts below. Both the district court and the court of appeals began with the premise that the substantive rules underlying the pre-litigation demand require-

ment are governed by federal law. The district court then dismissed the action because petitioner had not pleaded particularized facts demonstrating that demand should be excused as futile under federal law, and the court of appeals —while noting its agreement with the district court regarding the insufficiency of plaintiff's demand futility allegations—dismissed the action pursuant to a new "universal" demand requirement mandating demand in all cases involving federal claims, without regard for traditional notions of demand futility.

A. This Court has repeatedly held that "[c]orporations are creatures of state law," and that state law governs the powers of corporate directors unless the application of state law permits an action that is inconsistent with federal policy. *Burks v. Lasker*, 441 U.S. 471, 478-79, 486 (1979). The pre-litigation demand requirement plainly implicates the power of corporate directors to make decisions regarding the management of the business and affairs of corporations, such as the initiation of litigation proposed by minority shareholders, and is therefore governed by state law unless that state law is contrary to federal policy. Federal Rule 23.1 does not render the demand requirement an issue of federal law, because that Rule "does not require a demand, it only requires that the complaint allege with particularity what demand if any has been made. . . . [T]he Rule concerns itself solely with the adequacy of the pleadings; it creates no substantive rights." *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 543-44 (1984) (Stevens, J., concurring).

B. The relevant state's law is that of Maryland because respondent Cash Equivalent Fund, Inc. is a Maryland corporation. Under Maryland law, as in most states, a pre-litigation demand is required unless a shareholder pleads particularized facts demonstrating that the role of the corporation's directors (or the alleged domination and control of the directors by alleged wrongdoers) is such that demand would be "futile." Petitioner's allegations in this case are plainly insufficient to excuse demand under Maryland law, and no

federal policy is inconsistent with the imposition of such a demand requirement. Indeed, this Court held in *Burks* that no federal policy prohibits termination by disinterested directors under state law of shareholder actions brought pursuant to the Investment Company Act. *A fortiori*, no federal policy prohibits states from requiring a pre-litigation demand prior to a shareholder's filing of such a suit, or from excusing that demand where a demand would be "futile."

C. If this Court holds that federal law governs the pre-litigation demand requirement in this case, then the Court should reject the "universal" demand requirement adopted by the court of appeals, and affirm the dismissal of this action on the ground relied upon by the district court—petitioner's failure to plead particularized facts demonstrating demand futility under federal law. Requiring demand in all cases admittedly may produce beneficial corporate governance results, such as assuring directors a pre-litigation opportunity in all cases to examine shareholder grievances and take corrective action where appropriate, and saving litigants and courts the time and expense they would otherwise incur in litigating the demand futility issue.

Demand, however, is only one of many issues involved in derivative litigation, most of which—including what happens when a demand is refused—are indisputably state law issues under *Burks*. Requiring demand on a universal basis *as a matter of federal law* would plague the federal courts (and the litigants in these courts) with tremendous uncertainty and confusion, due to the close relationship between a *federal* universal demand requirement and the *state* corporate law issues that would surround such a requirement. Federal courts faced with board refusals of universal demands would be required to develop *de novo* state law standards upon which board refusals of demand would be evaluated. This endeavor would be embarked upon without the guidance of state court precedents, since, so long as there is no universal demand requirement in a particular state (and, to date, only three states—Florida, Georgia and

Michigan—require a universal demand), there can be no law in that state regarding board refusals of such a universal demand.

These state law issues which will arise in the future, of course, need not—and should not—be decided on the record before this Court, which includes neither a demand nor a refusal of a demand. The existence of these state law issues, however, demonstrates that the adoption of a universal demand rule at the federal level would create a procedural nightmare for the federal courts, leading to less predictability and more litigation than is the case under current law—a result which will far outweigh any benefits which might be achieved by adopting a federal universal demand requirement. The issue is thus best left to the states, to be decided upon in conjunction with all other state law corporate governance issues.

ARGUMENT

THE JUDGMENT OF THE COURT OF APPEALS SHOULD BE AFFIRMED BECAUSE A PRE-LITIGATION DEMAND IS REQUIRED UNDER THE GOVERNING STATE LAW

A. State Law Governs The Substantive Law Of Demand Underlying Federal Rule 23.1's Procedural Requirement Unless State Law Is Inconsistent With Federal Policy

This Court has held time and time again that "[c]orporations are creatures of state law." *Burks v. Lasker*, 441 U.S. 471, 478 (1979) (quoting *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 479 (1977), and *Cort v. Ash*, 422 U.S. 66, 84 (1975)). State law thus provides "the font of corporate directors' powers," and is "the first place one must look to determine the powers of corporate directors."

Burks, 441 U.S. at 478. *See also CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 89 (1987) ("[n]o principle of corporate law and practice is more firmly established than a State's authority to regulate domestic corporations").

This Court has also held that the *only* circumstance in which state law will not control the powers of corporate directors regarding the internal affairs of a corporation is where state law permits an action that is inconsistent with federal policy. In such cases, federal policy prevails. *Burks*, 441 U.S. at 478-79, 486. *See also Santa Fe*, 430 U.S. at 479 and *Cort*, 442 U.S. at 84 ("investors commit their funds to corporate directors on the understanding that, except where federal law *expressly* requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation") (emphasis in *Santa Fe*, but not *Cort*).

It is the law in virtually every state today that "[a] decision whether or not a corporation will sue an alleged wrongdoer is no different from any other corporate decision to be made in the collective discretion of the disinterested directors." *Burks*, 441 U.S. at 487 (Stewart, J., concurring) (citing *Swanson v. Traer*, 354 U.S. 114, 116 (1957), *United Copper Sec. Co. v. Amalgamated Copper Co.*, 244 U.S. 261, 263 (1917), and other cases). *See also, e.g., Spiegel v. Buntrock*, 571 A.2d 767, 772-73 (Del. 1990) ("A basic principle of the General Corporation Law of the State of Delaware is that directors, rather than shareholders, manage the business and affairs of the corporation. . . . The decision to bring a law suit or to refrain from litigating a claim on behalf of a corporation is a decision concerning the management of the corporation."); *Houle v. Low*, 407 Mass. 810, 821, 556 N.E.2d 51, 57 (1990) ("the decision whether to sue is properly left to the corporate authorities"); R. Clark, *Corporate Law* § 15.2, at 641 (1986) ("Whether to sue or not to sue is ordinarily a matter for the business' judgment of directors, just as is a decision that the corporation will make bricks instead of bottles.").

Therefore, prior to filing a shareholder derivative action, a shareholder generally must demand that the corporation's board of directors cause the corporation to pursue the alleged claim.

This pre-litigation demand requirement serves several important purposes. First, and most prominently, the requirement reflects the fundamental tenet of corporate law described above: The business and affairs of corporations, including decisions regarding litigation, are managed by or under the direction of directors, and not by individual shareholders.

Second, the demand requirement "enables corporate management to pursue alternative remedies, thus often ending unnecessary litigation." *Cramer v. General Tel. & Elecs. Corp.*, 582 F.2d 259, 275 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979). The requirement thus "serves the interests of judicial economy since a demand may often result in corrective action short of suit and, thereby, not only relieve the courts from entanglement in the management of internal corporate affairs, but also protect them from vain rulings on challenged acts which are later ratified by the board." *Barr v. Wackman*, 36 N.Y.2d 371, 378, 329 N.E.2d 180, 185-86, 368 N.Y.S.2d 497, 504-05 (1975). *See also Aronson v. Lewis*, 473 A.2d 805, 811-12 (Del. 1984) (demand requirement requires that a shareholder "exhaust his intracorporate remedies," and thus promotes "alternate dispute resolution, rather than immediate recourse to litigation").

Third, the demand requirement "affords corporate directors reasonable protection from the harassment of litigious dissident shareholders who might otherwise contest decisions on matters clearly within the directors' discretion," *Barr*, 36 N.Y.2d at 378, 329 N.E.2d at 186, 368 N.Y.S.2d at 504-05, and thereby discourages "strike suits" brought "not to remedy wrongs to the corporation, but to induce settlements beneficial to the named plaintiff or his counsel." *Cramer*,

582 F.2d at 275. *See also Aronson*, 473 A.2d at 812 (demand requirement "provide[s] a safeguard against strike suits"); *Barr*, 36 N.Y.2d at 378, 329 N.E.2d at 185-86, 368 N.Y.S.2d at 505 (demand requirement is "designed to discourage 'strike suits' by shareholders making reckless charges for personal gain rather than corporate benefit").

In light of these important purposes underlying the demand requirement, Justice Stevens observed in *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523 (1984), that "[i]t cannot be doubted that this type of requirement, designed to improve corporate governance, is one of substantive law." *Id.* at 544 n.2 (Stevens, J., concurring). *See also, e.g., Tandycrafts, Inc. v. Initio Partners*, 562 A.2d 1162, 1166 (Del. 1989) (the demand requirement is a "stricture[ ] of substantive law," and not a "mere formalit[y] of litigation").

The court of appeals recognized that "the demand requirement is an aspect of the division of authority between corporate managers and investors, a division usually governed by state law," that "*Burks* holds that federal law with respect to directors' power to dismiss derivative suits should be derived from state law, unless the state law is hostile to federal interests," and that "[p]erhaps the demand requirement, too, should be absorbed from state law." 908 F.2d at 1342 (Pet. App. 8a). The court of appeals nevertheless declined to decide whether the source of the demand requirement was state law or Federal Rule 23.1, because, until the filing of plaintiff's reply brief in the court of appeals, both parties had assumed that federal law governed the issue. *Id.* The Business Roundtable respectfully submits that the parties and the court of appeals erred by simply assuming that a procedural rule such as Federal Rule 23.1 could provide the

source of the demand requirement.[1]

Rule 23.1 provides (in relevant part) *only* that a derivative complaint in a federal action must "allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors . . . and the reasons for the plaintiff's failure to obtain the action or for not making the effort." As Justice Stevens stated in *Daily Income*, Rule 23.1 is nothing more than a procedural rule requiring that the plaintiff in a derivative action must:

> allege the facts that will enable a federal court to decide whether such a demand requirement has been satisfied; *Rule 23.1 is not the source of any such requirement*. The plain language of the Rule

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1. Numerous federal courts have similarly "assumed that the federal procedural rule establishes both the pleading guidelines as well as the substantive contours of the underlying demand requirement." *Gaubert v. Federal Home Loan Bank Bd.*, 863 F.2d 59, 63 (D.C. Cir. 1988). *See, e.g., Sax v. World Wide Press, Inc.*, 809 F.2d 610, 613 (9th Cir. 1987); *Lewis v. Graves*, 701 F.2d 245, 248-49 (2d Cir. 1983); *Greenspun v. Del E. Webb Corp.*, 634 F.2d 1204, 1209-10 (9th Cir. 1980); *In re Kauffman Mut. Fund Actions*, 479 F.2d 257, 263 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973). The trend since this Court's 1979 decision in *Burks*, however, has been either application of state law, *see, e.g., Starrels v. First Nat'l Bank*, 870 F.2d 1168, 1170 & n.4 (7th Cir. 1989); *First Am. Bank & Trust v. Frogel*, 726 F. Supp. 1292, 1298 (S.D. Fla. 1989); *Washington Bancorp. v. Washington*, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,893, at 94,885 (D.D.C. Sept. 26, 1989), or deferral of the issue on the ground that the results obtained by applying state and federal law are the same. *See, e.g., Gaubert*, 863 F.2d at 64; *Jordan v. Bowman Apple Prods. Co.*, 728 F. Supp. 409, 413 (W.D. Va. 1990); *Lou v. Belzberg*, 728 F. Supp. 1010, 1016 n.1 (S.D.N.Y. 1990); *Allison v. General Motors Corp.*, 604 F. Supp. 1106, 1116 (D. Del.), *aff'd mem.*, 782 F.2d 1026 (3d Cir. 1985).

The Business Roundtable urges the Court to reach this choice of law issue despite petitioner's failure to raise the issue until the eleventh hour, because of the importance of the issue, the uncertainty surrounding the issue, and the tremendous resources being devoted to the issue by litigants and the courts.

> makes that perfectly clear; *the Rule does not require a demand, it only requires that the complaint allege with particularity what demand if any has been made on the corporation. . . . Thus the Rule concerns itself solely with the adequacy of the pleadings; it creates no substantive rights.*

Daily Income, 464 U.S. at 543-44 (Stevens, J., concurring) (emphasis added).[2]

This construction of Rule 23.1, Justice Stevens also noted in *Daily Income*, is consistent with the Rules Enabling Act, which provides that general rules of practice and procedure—such as the Federal Rules of Civil Procedure—may not "abridge, enlarge or modify any substantive right." 28 U.S.C. § 2072. In Justice Stevens' words, "there is substantial doubt whether [Rule 23.1] could create [a substantive demand requirement] consistent with the Rules Enabling Act. Since the Rule does not clearly create such a substantive requirement by its express terms, it should not be lightly construed to do so and thereby alter substantive rights." 464 U.S. at 544 n.2 (Stevens, J., concurring) (citing *Mississippi Publishing Corp. v. Murphree*, 326 U.S. 438, 445-46 (1946), and *Sibbach v. Wilson & Co.*, 312 U.S. 1, 14 (1941)).

Finally, a very important practical reason mandates application of state law in federal court actions involving the pre-litigation demand requirement. Were different rules applied in federal and state court on the demand issue, a plaintiff who could plead diversity or pendent jurisdiction, or who had a federal cause of action which did not grant exclusive jurisdiction to federal courts (such as, for example, the Securities Act of 1933, 15 U.S.C. § 77a *et seq.*, and the Racketeer Influenced and Corrupt Organizations Act ("RICO"), 18 U.S.C. § 1961 *et seq.*), could shop for whatever forum offered him the most favorable demand requirement. As the court noted in *Allison v. General Motors Corp.*, 604 F. Supp. 1106 (D. Del.), *aff'd mem.*, 782 F.2d 1026 (3d Cir. 1985):

> It would be disquieting if a derivative plaintiff suing a Delaware corporation could achieve a different answer as to whether demand is excused as futile simply by filing, quite literally, 'across the street' in Chancery Court.

Id. at 1116 n.11.[3]

State law should accordingly govern the pre-litigation requirement, *unless* the demand requirement established by state law is inconsistent with federal policy.

B. State Law—In This Case Maryland Law—Mandates Dismissal Of This Action, And Is Not Inconsistent With Federal Policy

The parties here agree that the relevant state's law (if state law is to be applied) is the law of the State of Maryland, because respondent Cash Equivalent Fund, Inc. is

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2. *See also, e.g., Starrels v. First Nat'l Bank*, 870 F.2d 1168, 1170 (7th Cir. 1989) ("The issue . . . is whether the . . . complaint states with particularity (federal procedural requirement under Rule 23.1) facts which would excuse a demand upon the directors as futile under Delaware corporate law (substantive state law)."); *In re BankAmerica Sec. Litig.*, 636 F. Supp. 419, 421 (C.D. Cal. 1986) ("the substantive law of the state of incorporation should govern whether demand is sufficient or excused"; "federal law should determine whether the plaintiffs' demand or excuse has been pled with particularity sufficient to meet the requirements of the Federal Rules of Civil Procedure").

3. Indeed, for example, in *Hart v. General Motors Corp.*, 129 A.D.2d 179, 517 N.Y.S.2d 490 (1st Dep't), *leave to appeal denied*, 70 N.Y.2d 608, 515 N.E.2d 910, 521 N.Y.S.2d 225 (1987), the court noted that a derivative action on behalf of a Delaware corporation had been filed in New York rather than in Delaware precisely because "the outcome in New York may well differ from that in Delaware" on the demand issue. 129 A.D.2d at 186 & n.6, 517 N.Y.S.2d at 495 & n.6.

incorporated in Maryland (Pet. Br. at 11-13; SEC Br. at 18; Resp. Br. at __). Under Maryland law, as is the case under the law of most states, a pre-litigation demand is required in all derivative actions except those in which a shareholder plaintiff can plead facts demonstrating that the role of the corporation's directors (or the alleged domination and control of the directors by alleged wrongdoers) is such that demand would be "futile." *See, e.g., Zimmerman v. Bell*, 585 F. Supp. 512, 514 (D. Md. 1984); *Parish v. Maryland & Va. Milk Producers Ass'n*, 250 Md. 24, 82-83, 242 A.2d 512, 544-45 (1968), *cert. denied*, 404 U.S. 940 (1971). As explained fully in respondent's brief, petitioner's allegations in this case are plainly insufficient to excuse demand under Maryland law (Resp. Br. at __).

Nothing in federal law is inconsistent with the imposition of such a demand requirement. First, Federal Rule 23.1—as outlined above—is a procedural rather than a substantive requirement, and thus does not represent any federal policy other than a need to plead, with particularity, compliance with whatever demand requirement governs a particular action. Second, the Investment Company Act contains no express demand requirement or exception to the demand requirement. *Cf.* 15 U.S.C. § 78p(b) (explicitly legislating a demand requirement for actions under Section 16(b) of the Securities Exchange Act of 1934). This absence in the Investment Company Act of an express demand requirement is particularly significant, because corporation law is an area in which federal statutes do not "authorize the federal courts to fashion a complete body of federal law." *Burks*, 441 U.S. at 477. To the contrary, "in this field congressional legislation is generally enacted against the background of existing state law; Congress has never indicated that the entire corpus of state corporation law is to be replaced simply because a plaintiff's cause of action is based upon a federal statute." *Id.* at 478.

Moreover, *Burks* makes clear that the Investment Company Act does *not*, as a matter of federal policy, preclude the termination of derivative actions by disinterested

directors pursuant to state law:

> Congress' purpose in structuring the Act as it did is clear. It "was designed to place the unaffiliated directors in the role of "independent watchdogs," who would "furnish an independent check upon the management" of investment companies. . . . Without question, "[t]he function of these provisions with respect to unaffiliated directors [was] to supply an independent check on management and to provide a means for the representation of shareholder interests in investment company affairs." . . .
>
> Congress entrusted to the independent directors of investment companies, exercising the authority granted to them by state law, the primary responsibility for looking after the interests of the funds' shareholders. *There may well be situations in which the independent directors could reasonably believe that the best interests of the shareholders call for a decision not to sue—as, for example, where the costs of litigation to the corporation outweigh any potential recovery. In such cases, it would certainly be consistent with the Act to allow the independent directors to terminate a suit, even though not frivolous. Indeed, it would have been paradoxical for Congress to have been willing to rely largely upon "watchdogs" to protect shareholder interests and yet, where the "watchdogs" have done precisely that, require that they be totally muzzled.*

Id. at 484-85 (citations and footnotes omitted).

If no federal policy prohibits termination by disinterested directors under state law of shareholder actions brought pursuant to the Investment Company Act, then *a fortiori* no federal policy prohibits states from imposing a requirement that shareholders make a pre-litigation demand prior to filing such a suit, or from excusing that demand where a demand would be "futile" within the meaning of that term under the

particular state's corporate law.[4]

C. If This Court Determines That Federal Law Governs The Demand Issue, Then The Judgment Of The Court Of Appeals Should Be Affirmed On The Opinion Of The District Court, And The Court Of Appeals' Federal "Universal" Demand Requirement Should Be Rejected

If this Court holds that federal law governs the pre-litigation demand requirement in this case, then the Court should affirm the dismissal of this action on the ground relied upon by the district court—petitioner's failure to plead particularized facts demonstrating demand futility under federal law (659 F. Supp. at 1160-63 (Pet. App. 46a-56a); Resp. Br. at __).

This Court should also reject the court of appeals' determination that "the day is at hand" to "dispense[ ] with the [futility] exception altogether," and to test claims of demand futility "by *making* the demand rather than arguing about hypotheticals. If the firm declines to sue, the court can decide whether the board's decision is entitled to respect under state corporate law, which applies in light of the holding of *Burks*." 908 F.2d at 1346, 1347 (Pet. App. 18a, 20a) (emphasis in original).

The court of appeals' "universal" demand requirement has previously been proposed in the *Model Business Corporation Act* and by the drafters of the American Law Institute's on-going corporate governance project, *Principles of Corporate Governance: Analysis and Recommendations*. *See Model Business Corporation Act* § 7.42, *printed in Changes in the Model Business Corporation Act—Amendments Pertaining to Derivative Proceedings*, 45 Bus. Law. 1241 (1990); *Principles of Corporate Governance: Analysis and Recommendations* § 7.03 (Tentative Draft Nos. 8 & 9 Apr. 15, 1988 & Apr. 14, 1989).[5] To date, three states—Florida, Georgia and Michigan—have adopted this rule. *See* Fla. Stat. § 607.0740(2); Ga. Code Ann. § 14-2-742; Mich. Comp. Laws Ann. § 450.1493a(a).

The Official Comment to the *Model Business Corporation Act* explains that the rationale underlying a universal demand requirement is two-fold. First, even if a board of directors does not include a majority (or even any) disinterested directors, there is still no reason to deny the board an opportunity "to reexamine the act complained of in the

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4. Petitioner suggests that "state law cannot justify dismissal of the present action" (Pet. Br. at 10), citing *Galef v. Alexander*, 615 F.2d 51 (2d Cir. 1980), a case holding that the purpose underlying section 14(a) of the Securities Exchange Act, 15 U.S.C. § 78n(a)—an analogous provision to section 20(a) of the Investment Company Act, 15 U.S.C. § 80a-20(a), the provision at issue in this case—would be frustrated "if a director *who was made a defendant* in a derivative action for providing inadequate information in connection with a proxy solicitation were permitted to cause the dismissal of that action simply on the basis of his judgment that its pursuit was not in the best interests of the corporation." *Id.* at 63 (emphasis added). Here, however, petitioners concede that "in the present case the directors are not themselves defendants" (Pet. Br. at 10). Post-*Galef* decisions in the same Circuit which decided *Galef* have permitted directorial termination in such cases. *See Abramowitz v. Posner*, 672 F.2d 1025, 1031-32 (2d Cir. 1982); *Maldonado v. Flynn*, 671 F.2d 729, 731-32 (2d Cir. 1982).

Even more important, the issue in this case is not whether termination of this action by directors would frustrate federal policy, but whether requiring a pre-litigation demand would frustrate federal policy.

5. The most recent publicly disseminated draft of the provisions of *Principles of Corporate Governance* dealing with the proposed universal demand requirement and related rules governing shareholder derivative litigation is contained in Tentative Drafts Nos. 8 and 9. These provisions were tentatively approved by the ALI's membership at the Institute's 1988 and 1989 Annual Meetings, subject to further review and reconsideration prior to the completion of the project. The ALI's reporters are now in the process of revising these provisions, and plan to present them to the ALI's membership in 1992.

light of a potential lawsuit and take corrective action." Model Business Corp. Act § 7.42 Official Comment, *printed in Changes in the Model Business Corporation Act*, 45 Bus. Law. at 1244. Second, requiring demand on a universal basis will save litigants and courts the time and expense they would otherwise incur in litigating the demand futility issue. *Id*. The drafters of *Principles of Corporate Governance* similarly emphasize that a universal demand requirement "would eliminate much of the collateral litigation that today slows the pace and increases the cost of derivative litigation," while placing a "relatively costless" burden upon shareholders and possibly "induc[ing] the board to consider issues or take corrective action that either moots or permits the early resolution of the action." Tentative Draft No. 8 § 7.03 comment at 64-65.

The Business Roundtable agrees with the court of appeals and the drafters of the *Model Business Corporation Act* and *Principles of Corporate Governance* that requiring demand in all cases may well produce beneficial corporate governance results. The Business Roundtable also believes, however, that adoption of such a requirement at the federal rather than the state level would be an inappropriate exercise of federal power, for two reasons.

First, a universal demand requirement would conflict with Rule 23.1's express provision that "[t]he complaint shall allege with particularity the efforts, *if any*, made by the plaintiff to obtain the action the plaintiff desires from the directors . . . and the reasons for the plaintiff's failure to obtain the action *or for not making the effort*" (emphasis added). Any reading of Rule 23.1 which permits imposition of a universal demand requirement at the federal level would render the highlighted words mere surplusage, and should thus be rejected. *See, e.g., United States v. Menasche*, 348 U.S. 528, 538-39 (1955) ("'The cardinal principle of statutory construction is to save and not to destroy.' It is our duty 'to give effect, if possible, to every clause and word of a statute,' rather than to emasculate an entire section. . . .")

(citations omitted); 2A *Sutherland Statutes and Statutory Construction* § 46.06 (1984) ("[a] statute should be construed so that effect is given to all its provisions, so that no part will be inoperative or superfluous, void or insignificant") (footnotes omitted).

Second, and more important, the close relationship between a federal universal demand requirement and the numerous state law issues which would surround such a requirement would plague the federal courts (and litigants in the federal courts) with tremendous uncertainty and confusion. This uncertainty and confusion would far outweigh any benefits that might arise from a universal demand requirement, and militates against the adoption of such a universal demand rule at the federal level.

This point is illustrated by considering the two types of cases in which courts today are typically required to review board decisions either to refuse a shareholder demand or to seek to terminate already commenced derivative litigation, and the means by which demand refusals are dealt with in the *Model Business Corporation Act* and *Principles of Corporate Governance* formulations of the universal demand requirement.

"Demand Required" Cases. It is well settled under Delaware law[6] that a determination to refuse a demand by a

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6. "By any measure, Delaware is the preeminent state in corporation law. Over 40 percent of the companies listed on the New York Stock Exchange are incorporated in Delaware. A majority of the publicly traded Fortune 500 companies are Delaware corporations." 1 R. Balotti & J. Finkelstein, *The Delaware Law of Corporations and Business Organizations* F-1 (2d ed. 1990) (footnote omitted).

Courts outside of Delaware also often look to Delaware courts for guidance with corporate law issues, because the Delaware courts have more experience with these issues than courts in other jurisdictions. *See, e.g., Dynamics Corp. of Am. v. CTS Corp.*, 794 F.2d 250, 253 (7th Cir. 1986) ("Indiana takes its cues in matters of corporation law from the

(continued...)

board consisting of a majority of disinterested directors will be evaluated by the courts just like any other business decision by a board of directors, in accordance with the business judgment rule—"a presumption that in making a business decision, not involving self-interest, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Spiegel v. Buntrock*, 571 A.2d 767, 774 (Del. 1990). *See also*, *e.g.*, *id.* at 777 ("[I]f the requirements of the business judgment rule are met, the board of directors' decision not to pursue the derivative claim will be respected by the courts. In such cases, a board of directors' motion to dismiss an action filed by a shareholder, whose demand has been rejected, must be granted."); *Aronson v. Lewis*, 473 A.2d 805, 813 (Del. 1984); *Zapata Corp. v. Maldonado*, 430 A.2d 779, 784 & n.10 (Del. 1981).[7]

"Demand Excused" Cases. Where a majority of a corporation's directors are interested in the subject matter underlying a shareholder grievance and demand is excused, the directors do not have the option of refusing demand. In such a case, however, the board may appoint a "special litigation committee" consisting solely of disinterested directors to determine what action should be taken with

6. (...continued)
Delaware courts"), *rev'd on other grounds*, 481 U.S. 69 (1987); *Detwiler v. Offenbecher*, 728 F. Supp. 103, 147 n.17 (S.D.N.Y. 1989) ("Michigan courts look to Delaware law as a guide for adjudicating matters involving corporate law."); *Wieboldt Stores, Inc. v. Schottenstein*, 94 Bankr. 488, 509 n.29 (Bankr. N.D. Ill. 1988) ("Illinois courts have often looked to Delaware law for guidance in deciding previously undecided corporate law issues.").

7. The law is the same in every jurisdiction which has addressed the issue. *See generally* Block, Radin & Rosenzweig, *The Role of the Business Judgment Rule in Shareholder Litigation at the Turn of the Decade*, 45 Bus. Law. 469, 492-97 (1990) (containing state by state survey of the law).

respect to the litigation. *See*, *e.g.*, *Burks*, 441 U.S. at 473-75, 486. If the committee determines to seek dismissal of the litigation on the ground that prosecution of the action will not serve the best interests of the corporation, the committee's decision is reviewed by the courts pursuant to a stricter level of judicial scrutiny than the business judgment rule.

The Delaware courts, for instance, have developed a two-step test pursuant to which the Delaware Court of Chancery (1) reviews the independence and good faith of the special litigation committee and the bases supporting the committee's conclusion that litigation would not serve the corporation's best interests, with the corporation bearing the burden of proof on these issues, and (2) exercises its own "independent business judgment" concerning the merits of the committee's decision to seek dismissal if the court in its exercise of discretion deems such review appropriate in the particular case. *See*, *e.g.*, *Kaplan v. Wyatt*, 499 A.2d 1184, 1188 (Del. 1985), *aff'g* 484 A.2d 501, 508-09 (Del. 1984); *Zapata*, 430 A.2d at 788-89.

In New York, by contrast, judicial review of the merits of a special litigation committee's decision to seek dismissal is limited to the independence of the committee's members and the appropriateness and sufficiency of the committee's investigation. Judicial review of the substantive aspects of the decision that litigation would not serve the best interests of the corporation is not permitted. *See Auerbach v. Bennett*, 47 N.Y.2d 619, 633-34, 393 N.E.2d 994, 1002-03, 419 N.Y.S.2d 920, 920-29 (1979).

Other states have adopted even different formulations of the law governing cases in which demand is excused. *See*, *e.g.*, *Miller v. Register & Tribune Syndicate, Inc.*, 336 N.W.2d 709, 715-18 (Iowa 1983); *Houle v. Low*, 407 Mass. 810, 812-26, 556 N.E.2d 51, 53-60 (1990); *Alford v. Shaw*, 320 N.C. 465, 467-74, 358 S.E.2d 323, 325-28 (1987), *subsequent proceedings*, 327 N.C. 526, 398 S.E.2d 445 (1990).

The Model Business Corporation Act And Principles Of Corporate Governance Treatment Of Demand Refusals. The *Model Business Corporation Act* adheres to present law by "carry[ing] forward the distinction" between what are currently "demand required" and "demand excused" cases "by establishing pleading rules and allocating the burden of proof depending on whether there is a majority of independent directors." *Model Business Corporation Act* § 7.44 Official Comment, 45 Bus. Law. at 1251. Specifically, in derivative actions filed after refusal of a universal demand and in which the board consists of a majority of disinterested directors, the action "shall be dismissed by the court" unless the shareholder plaintiff alleges particularized facts establishing that the determination to refuse demand was not made by independent directors acting in good faith after conducting a reasonable inquiry. *Model Business Corporation Act* § 7.44. In cases in which a majority of the board does not consist of disinterested directors, however, the burden is upon the corporation to establish that a decision to refuse demand was made in good faith and on the basis of a reasonable inquiry. *Id.*

The most recent draft of *Principles of Corporate Governance* differs from the *Model Business Corporation Act* by providing for independent judicial review of the merits of a board decision not to litigate a particular claim even in cases in which a majority of the corporation's directors *are* disinterested, unless the claim involves a violation of the directorial fiduciary duty of care, as opposed to a violation of the directorial fiduciary duty of loyalty. *See* Tentative Draft Nos. 8 & 9 §§ 7.08, 7.10 & 7.11. As petitioner correctly notes, "virtually all derivative cases" involve allegations of self-dealing (Pet. Br. at 21) and thus violations

of the duty of loyalty.[8]

* * *

Federal courts faced with board refusals of federally mandated universal demands "should apply state law governing the authority of independent directors to discontinue derivative suits," unless the result reached under state law frustrates federal policy. *Burks*, 441 U.S. at 486. Since there is no universal demand requirement in most states (including Delaware), there have been no refusals of universal demands in most states. Barring changes in state law, there will in the future continue to be no refusals of universal demands in most states. Accordingly, unlike most federal court decisions involving state law, the decision regarding what state rule of

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8. Both petitioners and the Securities and Exchange Commission oppose adoption of a universal demand requirement on the ground that such a requirement might well "spell the death of all derivative actions" (Pet. Br. at 23), and "have troubling, and, in our view, impermissible, consequences for the enforcement of claims under the Investment Company Act" (SEC Br. at 24). These concerns seem to be based upon petitioner's and the SEC's fear that courts would evaluate all board refusals of universal demands pursuant to the business judgment rule, because that is the standard utilized under current law in cases in which demand is required—*i.e.*, in cases involving corporations having a majority of disinterested directors. As illustrated above, however, neither the *Model Business Corporation Act* nor the *Principles of Corporate Governance* formulations of the universal demand requirement require business judgment rule scrutiny in cases in which a majority of the corporation's directors are not disinterested.

Indeed, far from sounding the death knell for derivative litigation, the current draft of *Principles of Corporate Governance* tilts the pendulum far away from the business judgment rule standard of review pursuant to which petitioners and the SEC fear all decisions to refuse universal demands will be measured against. The *Principles of Corporate Governance* formulation has been sharply criticized on this ground. *See, e.g.*, Block, Radin & Rosenzweig, *supra* note 7, 45 Bus. Law. at 501-07; Dooley & Veasey, *The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 Bus. Law. 503 (1989).

law will govern a refusal of a federally mandated universal demand must be made without the guidance of state court precedents.

Federal courts asked to construe the law of a state such as Delaware following the refusal of a "universal" demand would thus have two choices. First, the court could begin by determining whether a "traditional" demand would have been required or excused under the applicable state's law (exactly the inquiry sought to be avoided by the universal demand requirement), and then apply that state's law to either the "demand required" or "demand excused" scenario at issue. In the alternative, the court could predict whether a particular state—assuming the state were to adopt a universal demand requirement—would follow the *Model Business Corporation Act* or the *Principles of Corporate Governance* approach, or some variation of one of these approaches.[9] Under either of these scenarios, federal courts would be developing state law without the guidance of state court precedents.

These state law issues which will arise in the future, of course, need not—and should not—be decided on the record before this Court, which includes neither a demand nor a refusal of a demand. The existence of these state law issues, however, demonstrates that while there may be much to be said on policy grounds in support of a universal pre-litigation demand requirement, adoption of such a rule *at the federal level* would create a procedural nightmare for the federal

9. Of the three states which have adopted universal demand requirements, two—Florida and Georgia—follow the *Model Business Corporation Act* approach, modified to provide only that a derivative action "may be dismissed" rather than "shall be dismissed" if the *Model Business Corporation Act* criteria have been satisfied. *See* Fla. Stat. § 607.0740(3); Ga. Code Ann. § 14-2-744. The third state—Michigan—follows the Model Act approach, without exception. *See* Mich. Comp. Laws Ann. § 450.1495.

courts. The result will be less predictability and more litigation than is the case under current law—a result which would far outweigh the benefits which might be achieved by adopting a federal universal demand requirement. The Business Roundtable respectfully submits that nothing could more aptly demonstrate the wisdom of leaving the ultimate determination regarding the policy considerations underlying the universal demand doctrine to the states, to be decided—as has been done in Florida, Georgia and Michigan—in conjunction with all related corporate governance issues.

CONCLUSION

For the reasons set forth above, the judgment of the court of appeals should be affirmed.

Respectfully submitted,

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